Corporate Governance Systems and their Impact on Performance of Companies

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Abstract: Lack of governance has always been an issue in Pakistan, restricting growth of its companies. The increased competition due to arrival of MNCs, well-equipped with best practices, emphasizes the need of good corporate governance systems according to socio-economic culture of Pakistan. A good corporate governance system helps accelerate the socio-economic growth of a country by maintaining a balance between rights of all stakeholders. The corporate governance models adopted by most of organizations in Pakistan and other developing nations include Anglo-US, German and Japanese models. The same are reviewed to evaluate their application in Pakistan. The study will help understand benefits and problems of mentioned corporate governance systems and also help design a system best for Pakistan ensuring balance of power and representation of all stakeholders that is one of the main reasons behind poor governance in Pakistan.

Keywords: Anglo-US model, German model, Japanese model, Corporate Governance, Stakeholders model

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1. Introduction

With the changing global scenario and transformation of Multinational Companies into Multinational Economies, the concept of corporate governance is also broadened. According to OECD "Corporate Governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board of directors, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set" (OECD, 1999). Simply corporate governance refers to the manner in which the affairs of a corporate body are or should be conducted in order to serve and protect the individual and collective interests of all stakeholders (Butt, 2008).

Corporations are of vital importance for the economy of a country. Pakistan is a developing country with a GDP of 304.952 billion US$ and per capita income of 1580 US$ (World Bank , 2018). Lack of availability of finance has always been a major hurdle in the growth of the corporate sector especially in under developing economies. Pakistan is also among those countries dealing with the same problem (Beenish, 2013). World Bank declared lack of access to finance as one of the major barriers to growth of more than 50% of SMEs (WBR, 2015). Certain manufacturing companies need huge investments and such capital intensive organizations can only be set up in the form of a joint stock company. The presence of joint stock companies ensures distributed profits and losses among all the people of the society as the total assets of a company are divided into easily purchasable and transferable shares. It also provides individuals the opportunity to invest (even with limited amounts) and harvest the profits, therefore maintaining equality and balance in the society (Pepelasis, 2011).

The corporate sector in Pakistan is mostly based on SMEs. According to IFC report (2012), out of 3.2 million enterprises in Pakistan, 3 million are SMEs contributing 30% to GDP and employing 70% of labor force whereas only 0.2 million are large scale manufacturing, that are mostly government or foreign owned. The limited number of large scale manufacturing organizations is also due to lack of investments. According to SME Policy 2007 by SMEDA, SME may be defined as the entity with a paid up capital of Rs.25 million providing employment to up to 250 people (Waheed, 2013). The investment of Rs. 25 million in sole proprietorship or even in partnership is also beyond capacity of so many people. Therefore the development of sound and stable stock market, facilitating ease in share investment and maintaining transparency, will not only help in growth of SMEs but also large scale capital intensive organizations can easily be established (SECP, 2002). Moreover, in the Islamic societies where “Halal Haraam” is always a consideration, providing ease in share investment would gain more positive response than bank fixed deposits (FD), bonds or certificates (Hussain, 2005). Secondly, the employment opportunities generated by SMEs are also limited as compared to those generated by large corporations. SMEs provide employment up to maximum of 250 persons whereas organizations having greater number of employees i.e. more than 250 are considered large scale organizations. In Pakistan, 3 million SMEs are quite insufficient to generate employment for majority of population. Apart from the limited number of large scale manufacturing organizations, lack of growth in SME sector is also evident by the similar statistics reported by SMEDA in 2018. Hence an increase in number of corporations is also required to increase employment opportunities (Muhammad, 2010).

1.1 Important Considerations in Corporate Governance system

The health of the corporate sector of a country defines its effective corporate governance system. According to OECD (OECD, 2015), the key considerations for Good Governance are:

i. Rights of Shareholders
ii. Equitable treatment of shareholders
iii. Role of stakeholders
iv. Disclosure & Transparency
v. Responsibilities of Board of Directors

OECD elaborated its corporate governance mechanism with the help of effective management in five dimensions that helps builds up good will and corporate image of the company in the market. These five dimensions give a brief but concrete outline of rights and obligations of all stakeholders and the way to manage them efficiently. Safeguarding the rights of share holders along with equitable treatment of all shareholders builds up the board's image, investor's trust and the company's goodwill in the stock market. The role of directors towards stakeholders and timely disclosure of all required financial and management details builds up the credibility and trustworthiness of board. This behavior consequently affects the perception and attitude of stakeholders regarding company's acts and strategies. The positive or negative attitude of stakeholder including creditors, employees, customers, and investors ultimately defines the company standing in the market. The above mentioned guidelines help understand the mechanism along with the rights and responsibilities of all the stakeholders. (Fernando, 2015)

A good corporate governance model properly elaborates the rights of all the stakeholders. Different mechanisms are followed by different countries as per their socio-economic cultures. The socio-economic culture of a country also helps understand the primary considerations of the people of the country and their approach towards investment (Al-Malkawi & Pillai, 2018). The constructive role and healthy participation of all the stakeholders also ensures good governance. These stakeholders can either be employees actively contributing to company's performance or the customer's feedback or complain regarding the quality of product. Positive role of stakeholder improves company's performance and guarantees transparency (Fernando, 2015). Although the organizations try to achieve economies of scope through implementation of same corporate governance mechanism but the practices of an organization vary from country to country. This is due to difference in the macro environments of countries. A company has to modify, adjust or manage the components of their micro environment (infrastructure, employees, distribution channel etc.) according to the macro environment of the operating country (Waheed, 2013).

1.2 Corporate Governance in Pakistan

Corporate governance plays a significant role in strengthening the long-term economic development of companies and countries. SECP was the first to introduce the Code of Corporate Governance for Pakistan in 2002 (SECP, 2002).

According to a survey of corporate governance practices in Pakistan, conducted by International Finance Corporation and SECP in 2007, 92% respondents prepare "annual statement of Ethics and Business Policy", 48% had "vision and Mission Statement", and none of the respondents have Code of Corporate Governance. On the other hand, it was also found that 53% have not implemented a formal remuneration system, and 55% did not have corporate governance improvement plan; whereas, 31% respondents did not identify the barriers to improve the corporate governance, 69% identified the barriers, 42% did not have qualified staff to implement the corporate governance practices (IFC, 2007).

This might be due to the reason that the basic knowledge of corporate governance is delivered at higher level studies whereas most of the people get into their professional lives after the completion of 14 years of education or sometimes less than that. The lack of awareness about the stock market, its mechanism, regulatory forces defining the corporate control mechanism and the corporate sector is a big threat for the whole economy. This barrier restricts the policy makers in making and implementing policies and strategies (Muhammad, 2010).

1.3 FDI Influence on Corporate Governance in Pakistan:

The economy of Pakistan is mostly based on foreign direct investment (Mir, 2010). Investments are made in different sectors including agriculture, mining, FMCG etc. A form of foreign investment is multinational companies or SBU’s (Strategic Business Unit). Currently, among the listed 165 companies in Pakistan, 47 are multinational companies. Moreover, these 47 companies have a number of brands that are working as separate SBU’s. Apparently, the contribution of MNC's in stock market seems to be around 30% but this stake is magnified due to the number of SBU’s working under these companies. Moreover, the volume of the investment of these 47 companies is much greater in comparison with the rest of 118 companies. Due the volume of these companies, the stake associated with them is also increased. This has resulted in a greater influence of these companies on the society, government, customers and rest of the stakeholders. Their stake in the economy also blesses them with the power to modify the macro environment of the host country (Beenish, 2013).

The CEO or head of these multinationals is mostly a person appointed from the home country. Besides investment, these companies also apply their home country’s management, HR practices and corporate governance models in the host country to achieve economies of scope. The CEO from host country also governs and monitors the smooth application of these managerial practices (Dariana, 2015). Most of the MNCs operating in Pakistan are from the American origin. Therefore, the corporate governance model mostly adopted is Anglo American governance model. There are other companies as well with different models like different Japanese organizations that are working in Pakistan (Tahir & Sabir, 2012).

Dr Shahid Javaid Burki- a long observer of Pakistan’s economy has stated “Pakistan can generate a greater bounce in its economy than India by creating better governance. It has occurred before in the country’s difficult economic history and could happen again.” (Improved Governance: Dawn, 12th, October 2010). Although the corporate governance models of highly developed countries are followed by so many foreign companies or the domestic firms but still the progress of the organizations present in Pakistan is not remarkable. Some organizations make modifications according to the changing scenario and the socioeconomic environment that are proved beneficial for the organization. Some of the examples include Askari bank and Bolan Castings etc (Gwadar, 2009).

The purpose of the study is to achieve the below mentioned objectives:

- To find out the loop holes that exists in the Anglo American, German or Japanese corporate governance system
- To make Comparison of companies working with anglo American model and any other model i.e. Japanese or German model
- To find out the different socioeconomic features that restricts its applicability in Pakistan.
- To highlight the features of different models supportive to their application in Pakistan.
- To elaborate guidelines for drafting a corporate governance model according to the socioeconomic culture of Pakistan.

2. Literature Review

The concept of corporate governance varies from country to country (Epstein, 2018). A very diversified and emergent literature is available showing the success stories of the capitalist nations, their strengths and weaknesses and their applied strategies, structures and mechanisms. Below is the literature evidences focusing on three of the selected and mostly adopted models.

2.1 Anglo-American Model

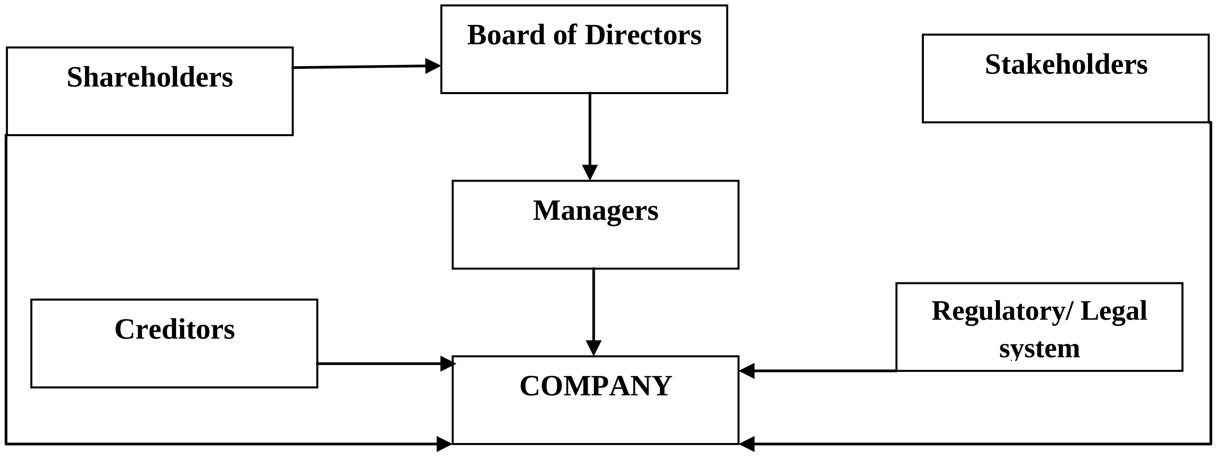

Figure 2.1: Anglo-American Model ***(Adopted from corporate governance by A.C. Fernando)***

The American model is also known as unitary model in which a single board is formed, comprising executive and non- executive directors. The power to elect a director that is the voting right lies with the shareholders. In such cases, where the directors are elected by the shareholders of the company, the directors seem more inclined towards them and the approach of governance tends to be more shareholders oriented. The legal and regulatory environment has most comprehensive policies also ensuring the protection of shareholders right. The excess inclination towards shareholders rights sometimes results in ignorance towards rights of other stakeholders (Davies, 2016). Although most of the MNC's are from US origin, defining the success of American governance model but apart from their strict regulatory environment, there are also numerous cases of violation of other stakeholder's rights. The application of shareholder wealth maximization model and ignorance towards employee participation in Director's selection may risk employee rights and their satisfaction level (Yermack, 2017). The application of such model in societies with weak regulatory environment results in violation of employees rights consequently reducing their morale and satisfaction. Employees are an asset for the organization but dissatisfied employee can sometimes ruin the company's progress (Wenger & Kaserer, 1998).

Although American model seems to go with equity financing but still institutional investors have a great contribution in American economy. Majority of top most brands have more than 50% of their capital structure based on debt financing allowing them to well reap the leverage benefits (Desender & Epure, 2015).

Contrary to Japanese and German models, banks or the financial institutions are not given the right to take part in the governance. This somehow reduces the level of trust between both parties. Although the disclosure policy is too strict but still the creditors can only see what is disclosed. As per the US anti monopoly legislation, no single bank can provide multiple services (Desender, Aguilera, Lópezpuertas & Crespi, 2016). Although this was to eliminate the influence of bank in the organization but expanding the borrowed financing to multiple investors sometimes proved to be the worst experience for the whole economy especially in times of crunch or slump in the economy. This is evident by the fact that the American economy experiences a slump after every 12-15 years which is mostly due to the bankruptcy of a company. Due to the expanded operations of MNC's and the presence of their stakeholders all over the world, these slumps in the economy also turn into global crunches. As the bankruptcy of a single company results in decline or the bankruptcy of the banks or institutions that had their stake in the company and so the chain goes on (Ducassy & Montandrau, 2015).

2.2 Japanese Model

The Japanese model is also known as the **business network model,** as it reflects the cultural relationship seen in the Japanese keiretsu. Keiretsu is a name given to a corporate structure in which a number of organizations link together, usually by taking small stakes in each other and usually as a result of having a close business relationship, often as suppliers to each other (Yafeh, 2001). The members of keiretsu are expected to collaborate as partner due to their assured long term relationships mutually providing technical assistance to the company. Although the American officials dislike it as they consider it a kind of family ownership but the Japanese firms often prosper due to the same strong and long term linkage as many issues of trust and transparency are resolved. The developed long term supplier and distribution channel relation results in effective supply chain management and timely distribution of goods thus contributing good governance within the organization and ensuring company’s success in the global scenario (McCahery, Sautner,, & Starks, 2016). The key stakeholders in Japanese model are the inside shareholders which comprises of affiliated companies or keiretsu and a main bank. Although this policy is against the US anti-monopoly legislation, that restricts one bank from providing multiple services, but proved beneficial results for the capital intensive organizations of Japan. Manufacturing companies need huge finances and availability of a strong financial institution plays a supportive role for them (Dariana, 2015). Mostly, the main bank plays the role of major shareholder instead of being a creditor. Although the absence of borrowed financing prohibits from reaping the leverage benefits but somehow this also reduces the chances of bankruptcy. Therefore, the Japanese model ensures slow and steady safe growth instead of the fast but risky growth present in American model due to multiplier leverage effect. Moreover, there also exists a difference between the natures of prosperous industries in both countries. Japan is famous for its automobile and electronics industry as it is home to world’s largest electronics companies such as Sony, Casio, Mitsubishi, Panasonic, Canon, Nikon, Yamaha etc. and the top automobile manufacturers of the world including Toyota, Honda, Suzuki and many others that are known for their innovative and quality vehicles and products. However, the prominent brands from American origin are mostly top FMCG / food brands like Unilever, P&G, Nestle, McDonalds, KFC, Star Bucks, and Dunkin Donuts etc.

Secondly, in both the cases i.e. either in borrowed or equity financing, one bank is selected to ensure and maintain long term relationship. The development of such long term relationship is proved to be a success especially for the development of capital intensive industries where it takes time to achieve economies and recover investment. This fact is also evident by the development of Japanese firms in the fields of technology and electronics (Yafeh, 2001).

Contrary to Anglo-US model, non-affiliated shareholders have no active participation in Japanese governance. Instead, the main decision making power lies with independent directors. Although the disclosure requirements are not very strict in Japanese model but that sometimes does not have much effect due to the fact that the level of trust is high because of long term relationships maintained in keiretsu (Ducassy & Montandrau, 2015).

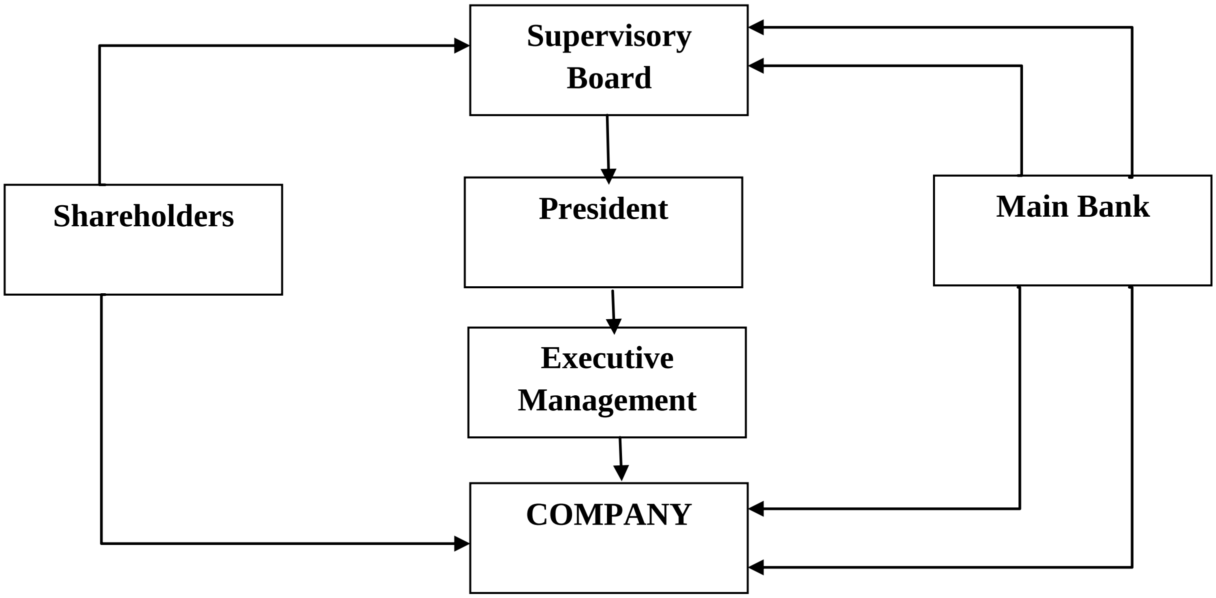

Figure 2.2: Japanese Model ***(Adopted from corporate governance by A.C. Fernando)***

2.3 German Model

The German model is also known as two-tier model as the governance is exercised by two boards. One is the supervisory board and the other is the management board. The members of the management board are selected by the shareholders. The bank representatives are also elected as part of the German management board. This is due to the fact that the banks hold long term stakes in German corporations (Bottenberg & Flickinger, 2017). Although, the German corporations prefer to go with bank financing instead of equity financing so as to take the benefit of the leverage effect. However, the participation of bank in the management board is compulsory which is contrary to the Japanese model where the participation of bank in management is kept optional (Davies, 2016). Therefore, the benefits of long term relationship are also well reaped in German model as well. The advantages associated with long term relation with the banks are easy availability of finance, low chances of bankruptcy, further growth opportunities in capital intensive organizations etc. During the last decades, the significant growth in the technology and electronics sector in Germany defines the success of German model (Jürgens, U. & Rupp, J., 2001).

The second aspect, unique in the German model is the appointment of supervisory board, which comprises of 50% of the total board and solely appointed by the employees and the labor unions of the corporation. This depicts the stakeholder capitalism and societal welfare approach of the German model (Wenger & Kaserer, 1998). Giving employees the right of participation in the board provides a number of benefits to the organization. It helps management better supervise employee’s affairs. The decisions are mutually taken by both the boards. This somehow reduces the chance of violation of employee’s rights and helps in building up employee satisfaction level. Therefore, the employees own the company, management and their decision as their own and with free consent. Secondly it builds up employee’s confidence on management decisions thus increasing their motivation and dedication towards work. The increasing level of employee satisfaction in Germany is evident by the success of its organization, country performance and increasing number of immigrants in Germany during last decades (Desender, Aguilera, Lópezpuertas & Crespi, 2016).

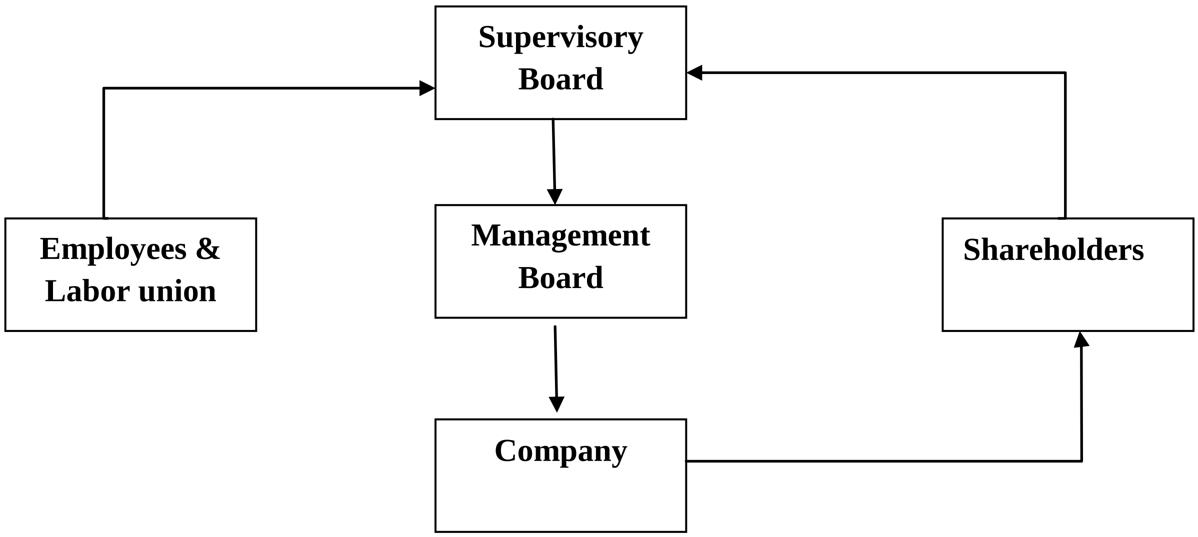

Figure 2.3: German Model ***(Adopted from corporate governance by A.C. Fernando)***

3. Discussion and Conclusion

From the above-mentioned discussion, following facts are revealed: Anglo American model, although successful in so developed countries but due to ineffective system of legal compliance and investor's protection, fails to produce desired results in so many countries (Soltani & Maupetit, 2015). The participation of creditors/ financial institutions in director's selection positively contributes to their trust thus enabling long term relationship. The creditor is deprived of this right in Anglo-American system consequently affecting the level of trust due to limited access to company's internal information. This is also evident by the regular bankruptcy of companies and slump in American economy that initiates from the bankruptcy of a single company and spreads as a global crunch (Tahir & Sabir, 2012). Moreover, the Anglo-American model works more on shareholder wealth maximization model that somehow seems ignorant towards rest of stakeholders. It is also evident by their act of restricting employees and creditors from voting rights for director's selection. This ruins the level of confidence among the stakeholders and consequently affects the performance of the organization (Aguilera & Crespi, 2016).

German model seems to be more inclined towards stakeholder capitalism model. Equal rights to director's selection are given to other stakeholders giving rise to the confidence on management and the board (Jürgens, U. & Rupp, J., 2001). This act also helps reduce the agency problem. Participation of employees in director's selection also helps in encouraging whistle blowing attitude within the employees of the organization. Moreover, in Pakistani scenario, where legal compliance is not very effective, it is required to build trust with increased transparency that is the core essence of German model and an essential part of organization performance. Giving confidence to employees by making them a part of a big decision helps develop team attitude. Many such HR management practices define a number of benefits to the organizations including enhanced efficiency and creativity of employees (Gwadar, 2009).

The same is the case with Japanese model that resembles more to family ownership. Family ownership is also more followed in Pakistan due to increased trust and reduced risk. This is also evident by the success of many family based organizations including Gul Ahmed, Younus, Hashoo and Nishat group etc (Hussain, 2005). In absence of legal compliance, shareholders and directors from being the part of same family help resolve many problems and dispute regarding rights of shareholder and their equitable treatment. Moreover, the family people raised with their future profession in mind not only play a beneficial role but prove to be an asset for the organization in the form of employees and the prospective directors. Growth by means of forward or backward integration helps define productive solution in supply chain and distribution channels with enhanced integration between stakeholders. These strategies help maintain long term performance of the organization (Mir, 2010).

It can be seen that all the Anglo-US Model, Japanese and German Models of corporate governance have their respective pros and cons. No individual model/system of corporate governance designed for any specific country can be applied in another country due to change of their socio-economic environment. There is strong need to formulate and adapt a hybrid model of corporate governance for the betterment of Pakistani economy. Therefore, a separate corporate governance system is required, eliminating flaws of Anglo-American system by adding good points of German and Japanese models as per the socio-economic environment of Pakistan. The model should include major stakeholders (shareholders, banks and employees) in director's selection by giving them voting rights. This will help ensure the transparency and avoid director's inclination towards any specific stakeholder thus safeguarding all stakeholders' rights.

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